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# The Work of an Investment Banking House

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## COMMERCIAL AND INVESTMENT BANKING

### *Difference in Matter*

*Commercial Banking.*—Let us first differentiate the work of commercial banking from that of investment banking. The commercial banker is engaged in financing the circulating capital of business enterprise. His control over capital is subject to certain very strict limitations. Most of it might be called a delegated control subject to revocation without notice. Though he may direct capital into certain channels he must be able to withdraw it quickly, if necessary to satisfy the demands of his depositors who have vested him with control over capital under the condition that they shall be able to revoke that control on demand and resume it for their own purposes. Therefore, the commercial banker who is conducting his business with careful regard for his obligation to repay depositors on demand, properly loans on the security of commodities or goods in the process of consumption which, as they enter into consumption, automatically provide the means for liquidating the loans of the commercial banker. He may, to be sure, make loans on the collateral of fixed capital securities, but only as by reason of their enjoying a quick market they possess the quality of ready liquidation in sale which affords the equivalent of liquidation through the processes of consumption. It should be noted too that this

loaning on security collateral takes place only after some one else has directed the capital represented by the securities into the enterprise on which the securities are based.

*Distribution of Surplus Capital.*—This shows the matter of commercial banking from the viewpoint of the commercial bank. Look at it for a moment from the viewpoint of the borrower from the commercial bank. A certain part of the capital of a business enterprise is required through the entire year and from year to year. Another part of the capital needs of any business varies from month to month. The inventories of a manufacturing concern, for example, have their peak and their valley. In addition to the raw material goods in process and finished product, the management of the enterprise must finance goods sold and delivered but not yet paid for. Seasonal variations cause this capital requirement to fluctuate widely. A business must render a return for its use of capital. Stated another way the cost of capital is an essential part of the cost of production. If it is possible to avoid paying for a whole year's use of capital, the actual use of which is required for only part of the year, that is good business. The capital which gives rise to these seasonal variations is that very circulating capital which by reason of its steady consumption is constantly providing the means to liquidate loans by which it may be financed. So the complex

development of our economic life has given rise to this nice adjustment, which is really an economy, providing the ability to shift the control over capital quickly from the place where, for the moment, it is not needed to the place where, at the moment, it is imperatively needed.

But any business enterprise has certain capital requirements which do not diminish through any natural seasonal variation. The land, the factory building, the machinery in the factory—when the capital committed to an enterprise takes these relatively enduring forms it remains a fixed quantity. Even though the plant or some part of it is idle for a time, and even though this idleness may be of periodical recurrence, we have devised no means of effecting a capital economy here. The capital is not fluid, but fixed, and we must count it a capital cost through the entire year, and year in and year out, whether we actually use it continuously or not. Besides having this capital which is “fixed” by reason of its physical aspects, a business enterprise has a certain minimum amount of circulating capital which, by reason of its constant quantity, gives rise to the same financing requirements as that part of the capital which is physically permanent. That is, in a manufacturing enterprise, for example, the inventory of raw material, work in process and finished product and the accounts receivable, all of which present a requirement for the financing of circulating capital, reach a minimum at some period of the year. Though in its physical quality this is circulating capital, or its representative in accounts receivable, the permanence of its quantity gives rise to the same

financing problem as the physically fixed capital assets of the business.

*Investment Banking.*—Here lies the field of the investment banker, in financing the capital requirements of business which are not subject to seasonal variation, principally the fixed assets which are not self liquidating through the rapidity with which they enter into consumption, but also that part of the circulating capital which, though constantly entering into consumption, is, by reason of its fixed quantity, not self-liquidating. By the term “self-liquidating,” of course, is meant furnishing the means for prompt repayment of the principal committed to the financing.

#### DIFFERENCE IN METHOD

Besides this fundamental difference in matter, a fundamental difference in method should be observed as between the work of the commercial and the work of the investment banker. The depositor in the case of the commercial banker has no choice in the risks to which his capital is committed. To offset this the commercial banker's own capital forms a guarantee fund which assumes the first hazard in all risks. The person committing his capital to an economic undertaking through an investment banker has a choice in his risk and the investment banker's own capital is in no way pledged to indemnify him, the investor, in the event of loss.

#### THE INVESTMENT BANKER AND PRIVATE ENTERPRISE

Without going further into the comparison of the commercial and the investment banker, which has been made only as a means of defining the

scope of the investment banker's activity, let us now consider the mechanism by means of which capital, not required in their own economic undertakings by those who have control over it, is committed to economic enterprise under the management of some one else. The entrusting of capital to the management of another is an essential element in the idea of investment as the word is commonly used, and hence the term investment banker as describing those through whom this commitment is made in the financing of the fixed capital assets of business.

*The Field of the Investment Banker.*

In the process of this commitment the investment banker uses his own capital as a means of clearance. He is a merchant buying on his own account with the risk of the transaction on him, not a broker performing a service only. The investment banker buys securities and sells them. Since his capital is not unlimited and his transactions are large he must arrange for credit. Yet the legal and business exigencies surrounding each transaction are such that credit is seldom extended to him by the vendor. Offsetting this fact is the fact that he seldom extends credit to the purchaser from him, the investor. But he must arrange loans to carry his goods, the securities in which he deals, until he sells. The method of doing this requires some description.

*The Method of the Investment Banker*

*Distribution of Investment.*—When the investment banker has committed himself to the purchase of an issue of securities, or even before actually making the commitment, he proceeds

to shift a large part of his risk as rapidly as possible. He forms an underwriting syndicate of investment bankers which assumes the entire risk of the transaction. He will retain such part of the risk as he desires or cannot shift by becoming himself a member of the syndicate of which he will be the manager. Though sometimes the members finance the carrying of their respective participations, more commonly the banker who has initiated the entire transaction arranges for the loan to carry the entire issue. To this end he seeks the commercial banker. For the purpose of the commercial banker the securities now in the process of distribution are like commodities entering into consumption. By reason of the market the investment banker is engaged in making, it is anticipated that the transaction will itself provide the means of liquidating the loan. Though there is not the same assurance that this will be the case as there is with a loan based on standard commodities, as food and clothing, or goods consumed in the necessary operations of our economic life, the consumption of which is imperative to human existence in the established social form, nevertheless, loans of this kind have become in financial centers a well recognized part of the business of those banks which have hitherto been designated in this article as commercial. Bank operations of this kind based on investment securities, whether in aid of the investment banker or the stock exchange broker, are sometimes called financial banking to distinguish them from operations based on tangible goods to which the term commercial banking would be more strictly applied.

*Shifting the Risk.*—Even though the

investment banker has shifted the risk of the transaction by forming an underwriting syndicate he may pledge his personal credit for the loan and put up the syndicate agreements as collateral along with the securities themselves. With the loan all arranged in this way the transaction is now ready for the "clearance," that is, for the payment of the purchase price to the issuer, the issuance of the securities and the delivery of them to the bank to be held as collateral. The precise form of the business varies a great deal with the nature of the transaction and no adequate inclusive general description can well be given.

There may well be a further shifting of the risk before this clearance operation. If the transaction has gone far enough, assumed sufficiently definite form, the underwriters may proceed to sell subject to the condition of "when, as and if issued and delivered." The securities may even be advertised in the press and by circular this way. When the advertising takes the form of an announcement of an offering for public subscription, and the subscription books are closed within an hour or two of their opening it need not always be assumed that an eager public has rushed in of its own accord. The probabilities are that a large amount of selling work was done before the subscription announcement.

#### *How the Investment Merchant Buys*

*Investigation of enterprise.*—In our description of the work of the investment banker we have followed one thread of the warp further than some of its parallel threads. So far we have followed the thread of distribution. How does the merchant of investments

buy the goods he sells? Sometimes an investment banker assumes the work of a promotor, assembles from the very beginnings the elements of an enterprise and follows it through its construction stage to its demonstration of an earning power. We will consider his work, however, only in relation to an enterprise already established. Those in control of such an enterprise seek the banker, usually, because they want to increase the business and in order to do so need to add to the capital account. Sometimes for one or more of various, good and sufficient reasons those in control wish to withdraw from the business, to sell out, and, since by reason of the magnitude of the enterprise the number of possible private purchasers is so small as to be negligible, they seek to sell to the investing public through the jobbing banker. The banker stays in business, however, through a reputation for the quality of the goods he sells. He must investigate and test his goods before adding them to his stock. He must test for earning power as being the quality which will provide dividends for stockholders, and interest and the provision for the repayment of principal for bondholders. He must consider the liability of this earning power to fluctuate depending on the kind of business involved as affecting the capacity of the enterprise to meet fixed charges and afford a probable continuity of preferred dividends. He must test the value of the assets, the cost of reproduction less depreciation. The business makes its earnings by reason of creating a value of some kind, a value of place, a value of form. How much of this added value is attributable to the use of capital, and how

much, therefore, of the earnings is capital likely to be able to continue to command.

*Earnings and Income.*—Though the banker must depend on his own judgment in making a purchase of securities, he needs facts and the judgments of expert technical knowledge on which to base his judgment. So when considering the merits of an enterprise as a basis of investment he calls in experts for several lines of technical investigation. We will assume that the enterprise is industrial. The banker needs to know the facts about earnings. The management of the corporation may be perfectly honest in its representations to the bankers and still state earnings incorrectly because themselves mistaken. Accounting practices are by no means universally sound. So, as a check on possible wilful misrepresentation, but more probable unintentional inaccuracy, the banker requires the audit of expert accountants running over such a period of years as may be considered sufficient to guard against a commitment based on exceptionally favorable earnings for a single year.

*Value of Assets.*—Though income is the first consideration, the value of assets is also highly important. If the employment of capital in the enterprise is unduly small in relation to the earnings, apparently elements other than capital contribute principally to the income, as management, or some especially favorable but probably not really permanent condition. Question may well arise as to the value of capital committed in the absence of the especially favorable element. What would the assets be worth to some other competent management? As an as-

surance of the probable continuity of income available to capital and of a liquidation value, in the event of some weakness that may develop in the management of the enterprise in its present form, the value of assets must be taken into account. So the banker needs an appraisal of the tangible assets. The auditors have passed such judgment as is possible on the value of the intangible assets, the bills and accounts receivable. The judgment is perhaps not based on very profound investigation, but it is the best practicable.

*Appraisal of Materials.*—The auditors, however, who are skilled in accounts, have no basis for judgment of the tangible values on which those accounts are largely based. So, both for the purpose of supplementing and enabling a check on the deductions drawn from the audit, the bankers have an appraisal made. This appraisal may be made simultaneously with the audit, and its results, or more especially the appraisal of the inventories of material, goods in process and finished product, taken advantage of in completing the report on the audit. So far as the fixed capital assets are concerned the appraisers estimate the cost of reproduction and deduct a proper allowance for depreciation. Such an appraisal, of course, leaves out of consideration special increases or decreases of value due to location or other causes than costs, but as these special advantages or disadvantages are reflected in earnings this is not of consequence. The appraisal serves the purpose for which it is taken.

The cost of reproducing the plant may be a certain amount, yet the plant may not be advantageously arranged

for operating purposes. The banker needs the opinion of a competent engineer on this matter. Such an opinion completes the list of expert investigations ordinarily made.

*Investment Merit.*—To the facts as ascertained by these expert investigations the banker must add the more general facts in forming his judgment of investment merit. He must consider such matters as whether the general geographical location is and will continue to be advantageous, the ability of the management, whether the enterprise is large enough to hold its own in the industry, the labor element, in short, the entire set of general business considerations.

*Kind of Securities to Be Issued.*—Before these investigations are undertaken the financing bargain has been made, that is, an agreement reached as to the kind and amount of securities to be issued and the price to be paid for them. This is done on the basis of representations by the management of the enterprise. The investigations are made to substantiate these representations, and the financing bargain is made conditional on this substantiation.

In arriving at the financing bargain the management and its attorneys and the bankers and their attorneys all have a part. The management of the enterprise and the bankers state the results they wish to arrive at and, in a general way, the means. The attorneys indicate how far these results and means are legally practicable. In this way the bargain is made which includes as part of its terms the form of security to be issued. The experts proceed with their investigations, which we will assume do substantiate the representa-

tions of the management. The attorneys proceed with the legal matters necessary to carry out the bargain. The bankers go ahead with their preparations for the ultimate distribution of the securities. This involves the formation of the syndicate, as already indicated, the preparation of the circular and any other matters looking forward to the final offering of the securities to the investing public.

*The Sale of Securities.*—The preparation of the circular and other advertising matter is by no means an unimportant part of the work antecedent to the sale of the securities. Statements made in the circular constitute the representations on the basis of which the securities are sold. Every care must, therefore, be taken to have these statements accurate. The banker's reputation, to say nothing of legal liability, depends on their accuracy. Yet, naturally, the circular should make as good a showing for the business as consistent with the facts. If there are any faults, however, they are likely to be faults of omission rather than of commission.

We will not undertake to describe the processes by which an investment banker develops the clientele which is the foundation of his business. The forming of business connections through the agencies of the salesman, through personal relationship, and through such value as the printed advertisement, may follow a course for investment banking fairly similar to that for any other form of business enterprise. The problem is especially difficult in that the thing which the investment banker has to sell consists of intangible values.

### THE INVESTMENT BANKER AND PUBLIC FINANCE

For the sake of clarity in the particular description, we have so far confined ourselves to the work the investment banker performs in directing investment in private enterprise and have neglected his relationship to public finance. The community acting in its organized capacity as the sovereign state, including the municipal agencies of the state, makes its primary provision of funds substantially in two ways, by taxation and by borrowing, that is, the enforced levy and the voluntary loan. Though the funds may be provided in the first instance by the voluntary loan the repayment of the loan and, therefore, the ultimate source of the funds lies in the enforced levy.

#### *Public Loans*

The loan is properly resorted to as a source of immediate funds for such extraordinary expenditure that to levy for the whole amount would interfere with the economic functioning or productive power of the community. Two men equally able to pay in the long run may differ very widely in their ability to make immediate payment. One man may, without interfering with his productive power, part with his private control over capital to many times the amount of another man of equal worth. If an immediate tax levy would seriously interfere with the productive power of the other man, it is a matter of expediency to borrow part of funds immediately required on such terms as make it advantageous to those members of the community whose wealth is of such a nature that they can part with con-

trol over more than their proportionate share for tax purposes without interfering with their productive power. It may be remarked that no element of patriotism is involved in the transaction which would make it praiseworthy to loan to the government on terms less advantageous than a good bargain to the lender. The ultimate beneficiary is not the government but the taxpayer who is not in a position to part with his proportion of the necessary funds without too seriously impairing his economic efficiency. During the recent war the investment bankers of this country contributed their services in the flotation of the government loans. They not only made no profit but also suffered a positive loss through their running expenses. There was no more reason why they should contribute their services without pay and suffer the loss of their operating expense than that the maker of munitions of war should do the same thing.

#### *The Investment Banker a Merchant of Credit*

Ordinarily the investment banker acts as a merchant of credit in the case of government and municipal loans just as he does in the case of the financing of private corporations. In the case of the private corporation, however, the sale to the banker is a private sale, that is, the corporation does not offer its securities generally to whoever will come and buy, but privately seeks a particular banker, and if unable to do business with him seeks another. The regular course of business with public securities, however, is to offer them publicly to the highest bidder. If the banker seeks to buy he must

take what is offered. He does not have the opportunity he has with the private enterprise to take part, and usually much the greater part, in shaping up the investment contract expressed in the security. Since public securities rest on the taxing power as the one form of provision for payment, and usually all the issues have exactly the same claim on the taxing power, the opportunity for variation in the investment contract is confined to purely formal matters of the security, as the term and rate. So the lack of opportunity to take a part in the shaping up of the issue is not as disadvantageous as it would be in the case of securities of private corporations.

#### *Public Sale of Securities*

The business of financing the municipalities is highly developed and the fact of the public rather than the private sale by the issuer of the securities makes some fundamental differences. Since the purchaser does not know that he is to get the securities until it is time also for him to pay the money for them, there is not the same opportunity to shift the risk. Any syndicate formed before the purchase and payment is a joint account rather than an underwriting syndicate, that is, a joining in the risk as a primary purchaser rather than taking an assumption of the risk as a secondary purchaser. The same reason prevents any shifting of the risk to the investor before the time of payment. Since the purchase is uncertain it is not worth while to undertake the work and the banker has really nothing to offer.

Another respect in which the purchase of municipal securities differs from purchasing securities of private

corporations lies in the lack of special independent investigation, other than legal, in the case of the municipal security. It is in the nature of the transaction that the vendor's statement of assessed values and of financial position should be accepted by the purchaser. The purchaser does not, however, accept the legal proceedings as being necessarily adequate. The legality of the issue of municipal securities is so highly technical a matter that the investment banker always requires an independent report on legality, and the importance of this is indicated by the large percentage of cases in which the municipal bond attorney detects some flaw in the proceedings which requires remedy.

#### CREATION OF INVESTMENT MARKET

This description of the work of an investment banker has confined itself to his business as a merchant in credit. He has one function which the merchant in ordinary commodities does not have. The ordinary commodity goes its straight course direct to consumption. A security, however, is not consumed in use and the financing of it is, therefore, not liquidated in the consumption process. The only way in which the investor can liquidate a security with a long term still to run, or without maturity, as stocks, is to put his investment in the market again. A very considerable part of the economic service performed by the investment banker consists of his creation of this market. The processes by which it is created, through brokers, through telephonic, telegraphic and mail inter-relationships among the banking houses, through the medium of the organized exchanges, through

direct dealings with the bankers' own clientele are all matters that would require another article for telling. It is enough to say here that liquidity in sale is an important element of eco-

nomic value, and this value, when present, is one of the creations in one form or another of the investment banker.